

Internal Revenue Service

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:BR4

PLR-128319-06

Date:

September 26, 2006

Legend

Reciprocal =

Attorney-in-fact (AIF) =

State =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Dear :

This letter responds to your June 1, 2006 letter, supplemented by your August 29, 2006 letter, requesting the Commissioner's consent to a revocation of Reciprocal's election to be taxed in accordance with section 835(a) of the Internal Revenue Code (formerly section 826(a)), effective for the tax year ending December 31, 2006.

FACTS

Reciprocal represents that it is a reciprocal inter-insurance exchange subject to tax under section 831. Reciprocal was organized in Year 1 under State's mutual benefit law and is presently regulated as an insurance company in nine states. Effective for Year 2, Reciprocal made an election under section 826(a) (now section 835(a)) to be subject to the limitation provided in section 826(b) (now section 835(b)). Pursuant to its election, Reciprocal has been subject to the provisions of section 835 (and its predecessor former section 826) for all years from Year 2 to the present.

Reciprocal represents that since attorney-in-facts's (AIF's) formation in Year 3, AIF has managed Reciprocal's insurance business. In consideration for its services, Reciprocal pays AIF a fee based on a percentage of Reciprocal's earned premiums, and reimburses AIF for costs incurred on Reciprocal's behalf.

Pursuant to its section 835(a) election, Reciprocal has, in effect, been taxed on a combined basis with AIF since Year 2. Reciprocal requests our consent to revoke its section 835(a) election because it no longer enjoys an economic benefit from the election. Reciprocal explains that the tax benefit it received from the election eroded due to changes in the law, such as the 1986 repeal of the protection against loss accounts (PAL), but that it retained a tax benefit by keeping the election in place while it was operating at a loss because it could avail itself of the refundable credit.

Reciprocal explains, however, that once it became profitable in Year 4, this last remaining tax benefit was eliminated. At that point, Reciprocal was no longer able to claim the refundable credit for taxes paid by the AIF. Instead, Reciprocal has used the credit to offset the taxes AIF paid on the AIF's income attributable to Reciprocal, which Reciprocal has been including in its income pursuant to the election. Thus, since Year 4, the section 835(a) election has provided no tax benefit to Reciprocal. As illustrated by Reciprocal, in Year 5, the tax Reciprocal reported on its tax return would have been the same regardless of whether the election was in place or not.

In further support of its request for a revocation of its section 835(a) election, Reciprocal explains that despite the fact it does not receive an economic benefit from the election, it incurs compliance costs to produce the annual informational tax filings required by section 1.826-3(b).

LAW

Reciprocal underwriters and inter-insurers (reciprocals) conduct insurance business differently than ordinary mutual insurance companies in that their insurance business is conducted by two separate entities. An ordinary mutual insurance company receives all of the premium income from insurance, pays losses, and manages the company's insurance activities. A reciprocal pays its insurance losses, but an "attorney-in-fact" performs all, or most of, the insurance functions, such as writing policies, collecting premiums, settling claims, keeping records, etc., and pays the related expenses, for a portion of the premium income of the reciprocal.¹

In 1962, Congress enacted section 826, which was redesignated as section 835 by the Tax Reform Act of 1986,² to tax mutual companies (including reciprocals) on both their investment and underwriting income. However, in recognition of their unique form of operation with an attorney-in-fact, section 826(a) allowed a reciprocal to elect to, in effect, combine certain income of its attorney-in-fact with its own underwriting income.

In addition, former section 826 allowed mutual companies (including reciprocals) to defer recognition of some of their income by allocating it to a bookkeeping PAL account. This was done to provide mutual companies a source of capital to enable them to compete with stock companies in the event of a catastrophic loss. Amounts set aside in the PAL account that were not used to pay losses were generally excluded from taxation for five years and included in taxable income in the sixth year. Electing reciprocals benefited more from the existence of the PAL accounts than non-electing reciprocals because by including the AIF's income in their own, electing reciprocals were able to set aside a greater amount in their PAL accounts. PAL accounts, however, were repealed by the Tax Reform Act of 1986 for taxable years beginning after December 31, 1986.³

Under section 835(a), an electing reciprocal increases its taxable income by the income of the attorney-in-fact that is attributable to its business with the reciprocal. Section 1.826-1(a). The electing reciprocal then receives a credit for the taxes paid by the attorney-in-fact with respect to the income attributed to the reciprocal to avoid double taxation of the income. Section 835(d). In addition, the electing reciprocal deducts amounts it paid to or that were incurred by the attorney-in-fact. The reciprocal's deductions are limited, though, to the deductions by the attorney-in-fact that are allocable to the income received by the attorney-in-fact from the reciprocal. Section 835(b). Electing reciprocals must comply with the annual tax information reporting requirements set forth in section 1.826-1(e).

¹ S. Rep. No. 87-1881 at 57-58 (1962), 1962-3 C.B. 707, 763.

² Tax Reform Act of 1986, Pub. L. No. 99-514, section 1024 (Oct. 22, 1986).

³ Id.

A section 835(a) election is effective for the taxable year for which it is made and all succeeding taxable years, and may not be revoked without the consent of the Secretary. Section 1.826-1(d) provides that the Commissioner's consent to a revocation of a section 835(a) election will be based upon the facts and circumstances of each particular case.

CONCLUSION

Based upon the specific facts and circumstances of this case, consent is hereby granted to revoke Reciprocal's section 835(a) election, effective for the tax year ending December 31, 2006. Our conclusion is based on the fact that Reciprocal has not received an economic benefit from the section 835(a) election for several years, and continues to incur compliance costs related to the tax reporting requirements imposed on electing reciprocals by section 1.826-1(e).

Reciprocal represents that it will not make a section 835(a) election for any of the first five taxable years following the year to which this consent relates.

The ruling contained in this letter is based upon the information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. No opinion is expressed or implied with respect to the application of any Code section or subsection not specifically referenced in this ruling letter.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized representative. A copy of this letter must be attached to Reciprocal's federal income tax return.

Sincerely,

/S/

Donald J. Drees, Jr.
Acting Branch Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)